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Partially Executed Ultra Vires Contracts of Private Corporations

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PARTIALLY EXECUTED ULTRA VIRES CONTRACTS OF PRIVATE CORPORATIONS

I. PRELIMINARY CONSIDERATIONS

The term "ultra vires," in its proper sense, "denotes some act or transaction on the part of a corporation which, although not unlawful or contrary to public policy if done or executed by an individual, is yet beyond the legitimate powers of the corporation as they are defined by the statutes under which it is formed, or which are applicable to it, or by its charter or incorporation papers." 2 Machen, Corp. Sec. 1012.

All such ultra vires contracts may be divided into four classes. (1) They may be wholly executory on both sides; or (2) they may be fully executed on both sides; or (3) they may be fully executed on one side but not on the other; or (4) they may be partially executed, i. e. partly performed on one or both sides, but not fully performed on either side.

As to the law applicable to the first two classes, all of our courts are in substantial agreement. 3 Fletcher Cyclopedia Corp., Secs. 1530, 1559. Neither kind may be made the basis of an action. There is one case, however, which is an exception to the rule that a contract of the first class will not be enforced. Harris v. Ind. Gas Co. (1907), 76 Kan. 750, 92 Pac. 1123.

As to the third class, there are three lines of decision:

"First, that the performance never precludes the other party from urging ultra vires. This is the rule of the Supreme Court of the United States * * *. It is followed by a few, but rejected by most, of the State courts." See 131 U. S. 371 for statement of three reasons in support of this rule.

"Second, that the performance precludes the right to urge ultra vires in all cases where the party urging it has received the benefit of the contract. This rule is based largely on the decisions of the courts of New York; * * * and may be stated to be the prevailing rule in the United States." Fletcher Cyc. Corp., Sec. 1536.

Third, that if the contract relates to a matter wholly outside the charter powers of the corporation, the other party may always urge ultra vires as a defense; but that if the contract involves merely an excessive use of power conferred, then ultra vires may not be urged. This view represents the Illinois rule.

National Home Bldg. and L. Ass'n vs. Home S. Bank (1899), 181 Ill. 35.

Wisconsin is in accord with the second view. *McElroy vs. Minn. Percheron Horse Co.*, 96 Wis. 317; *Security Nat. Bank vs. St. Croix Power Co.*, 117 Wis. 211; *Witter vs. Milling Co.*, 78 Wis. 543; *Bigelow vs. R. Co.*, 104 Wis. 109; *Eastman vs. Parkinson*, 133 Wis. 375; 98 Wis. 203.

II. THE FOURTH CLASS: QUESTIONS INVOLVED

An analysis of the question of partially executed ultra vires contracts gives rise to five questions. These are: (1) Is the contract in question partially performed? (2) If it is, ought the party in default be compelled to perform the unexecuted residue of his contract, or be made liable in damages for his refusal so to do? (3) If it is held that the unexecuted residue of the contract cannot be made the basis of a suit, will the court allow the party not in default to recover upon the contract itself so far as executed? (4) Or will the plaintiff's recovery be limited solely to a recovery aside from the contract, in quantum meruit for the value of what he parted with under the contract? (5) Will a court decree a rescission of such a contract and restoration of property parted with thereunder, in a suit for such purpose brought by one party to the contract, where the other party to the contract has not in any way repudiated the same? We shall consider each of these questions in order.

(1) *Is the contract one that is partially performed?*

This is the rock upon which the courts sometimes divide. The contract before the court for construction is generally one of the continuing species, such as a lease for a term of years; or a partnership agreement; or contracts of employment for a definite term, etc. But of all such contracts, the courts most often find difficulty in the construction that is to be put upon leases. Some courts have held unexpired leases to be fully executed contracts on the lessor's side, and hence not subject to the rules governing partially performed contracts. In the case of *St. Louis, Vandalia & Terre Haute R. C. vs. T. H. & I. R. Co.* (1891), 145 U. S. 393, for example, the plaintiff had leased its road to the defendant for 999 years, and although the lessee had been in possession but 17 years of the term, the court held the lease to be fully executed on the lessor's side. It was said, "The contract has been fully executed on the part of the plaintiff by the actual transfer of its

railroad and franchise to the defendant; and the defendant has held the property, and paid the stipulated consideration from time to time, for 17 years, and has taken no steps to rescind or repudiate the contract." In accord with this case is, *Pittsburgh, J., E. & E. R. Co. vs. Altoona & B. C. R. Co.,* 196 Pa. St. 452. It is difficult to understand how an unexpired lease can be construed other than as a partially performed contract. Such contract has not been fully performed on either side, since the lessee must pay rent and perform other covenants throughout the life of the lease, and the lessor likewise must perform the covenants on his side for the residue of the term, such as the covenant of quiet title, etc. If the contract is fully executed on the lessor's side, what is to prevent him from demanding the rent for the full term?

Most cases, however, do hold that an unexpired lease is a partially performed contract, and not fully performed on the lessor's side. And the case in 145 U. S. before referred to seems clearly out of line with earlier cases in the same and other Federal courts which hold to the theory that an unexpired lease is a partially performed contract. *Thomas vs. West Jersey R. Co.,* 101 U. S. 71; *Penn. R. Co. vs. St. Louis, etc., R. Co.,* 118 U. S. 290; see also, *A. & P. Tel. Co. vs. U. P. R. Co.,* 1 Fed. 745. The Alabama courts also view such a lease as a partially performed contract. *Memphis & C. R. Co. vs. Grayson,* 88 Ala. 572, 7 So. 122.

(2) *Ought the party in default be compelled to perform the unexecuted residue of his contract, or be made liable in damages for his refusal to perform?*

However the Federal and State courts may differ as to whether the principle of estoppel applies in cases where the contract is fully performed on one side, they are nearly unanimous in holding that where a party to a partially performed ultra vires contract repudiates it and refuses to perform further, there is no remedy legal or equitable by which the other party to the contract can compel performance of the residue of the contract, or recover damages for the non-performance thereof. Some of the cases follow.

In *Thomas vs. West Jersey R. Co.* (1879), 101 U. S. 71, the action was brought to enforce the unexecuted part of a lease which was ultra vires. The lease was for a term of twenty

years, but at the end of four or five years, the lessee corporation repudiated the same. The court said:

> "What is sought in the case before us is the enforcement of the unexecuted part of this agreement. So far as it has been executed, namely, the four or five years of action under it, the accounts have been adjusted, and each party has received what he was entitled to by its terms. There remains unperformed the covenant to arbitrate with regard to the value of the contract. It is the damages provided for in that clause of the contract that are sued for in this action, damages for a material part of the contract never performed; damages for the value of a contract that was void. * * * Having entered into the agreement, it was the duty of the company to rescind or abandon it at the earliest moment. This duty was independent of the clause in the contract which gave them the right to do it. Though they delayed its performance for several years, it was nevertheless a rightful act when it was done. Can this performance of a legal duty—a duty both to stockholders of the company and to the public—give to plaintiffs a right of action? Can they found such a right on an agreement void for want of corporate authority and forbidden by the policy of the law? To hold that they can is, in our opinion, to hold that any act performed in executing a void contract makes all its parts valid, and that the more that is done under a contract forbidden by law, the stronger is the claim to its enforcement by the courts."

This decision was followed in *Penn. R. Co. vs. St. Louis, A. & T. H. R. Co.* (1885), 118 U. S. 290, where an action brought for the specific enforcement of an ultra vires lease of a railway was held not to be maintainable. The court said:

> "We know of no well considered case where a corporation which is party to a continuing contract which it had no power to make, which seeks to retract, and refuses to proceed further, can be compelled to do so."

This same doctrine has been applied in other cases. *Oregon R. & Nav. Co. vs. Oregonian R. C.* (1884), 130 U. S. 1, and cases cited in L. R. A. 1917 A 757. Also *A. & P. Tel. Co. vs. U. P. R. Co.*, 1 Fed. 745.

The rule in the State courts is in general the same. In *Mallory vs. Hanaur Oil Works* (1888), 86 Tenn. 598, 8 S. W. 396, two corporations formed a partnership, and placed their plants under the charge of a joint committee. The arrangement was to continue for a term of three years, but at the end of the

second year the plaintiff corporation repudiated it and brought action to recover possession of its plant. The court said:

> "As to the unexpired time during which the defendants in error might be deprived of the use of their property, and subjected to the hazards of another year's operations, it was not an executed contract. The possession obtained under this contract was illegal, and it was the duty of the officers of the Hanaur company to renounce the arrangement and recover possession. There are cases where, an invalid contract being fully executed, the courts will not entertain a suit to recover money or property transferred under such agreement, or, if they do interfere, will do so only upon equitable terms. But the defense here made would result, if successful, in enforcing the performance of the unexecuted part of a void contract. It is not a case of contract fully executed. The part remaining to be executed is a material part, and is beyond the power of defendant in error to make or sanction. Having entered into it, it was its duty to rescind or abandon it. * * * That the defendant in error has submitted to a void contract, by which it has been deprived of the use of its property for two years, furnishes no sound reason why it shall submit for three years. To hold that it did would be to apply the doctrine of part performance in a way to perfect and legalize illegal contracts which were partly performed."

In *Bowman Dairy Co. vs. Mooney* (1890), 41 Mo. App. 665, the court refused to enforce the residue of a partially performed ultra vires contract of employment. The court said that so long as neither side of the contract had been fully performed, there was a lack of mutuality in the contract, and that it could therefore not be enforced against either party. It was also said,

> "So long as such a contract * * * has not been fully performed by either party, the courts will not sustain any kind of action based upon it. The reason is that the enforcement of such a contract would be against public policy, and in direct violation of law." Further, "In order to defeat the defendant it must appear that the plaintiff has fully performed the contract. If such be the case, then the infraction of the law has already taken place, which would eliminate all questions of public policy from the case, and allow the courts to deal with the contract on equitable principles."

The New York courts also hold that where a contract is partially performed, there can be no enforcement of the unperformed residue, nor can damages be recovered for breach of

contract in refusing to perform such residue. *Bath Gas Light Co. vs. Claffy* (1896) 151 N. Y. 24, 45 N. E. 390. Other cases holding the same way are: *Memphis & C. R. Co. vs. Grayson,* 88 Ala. 572, 7 So. 122; *Greenville etc., Warehouse Co. vs. Planter's etc. Warehouse Co.,* 70 Miss. 669, 13 So. 879; *Sabine Tram. Co. vs. Bancroft, Court of Civil Appeals of Texas* (1897), 40 S. W. 837. In the latter case the court stated the rule in this way:

> "We conclude that the partnership formed between appellant and appellee was unauthorized by the statute and contrary to public policy, and, while those parts of the contract which have been executed should be enforced between the parties, no enforcement of the unexecuted part of it can be properly demanded."

In the Michigan case of *Day vs. Spiral Springs Buggy Co.,* 57 Mich. 146, 23 N. W. 628, it was held, that the fact that a contract for the sale and delivery of goods on instalments had been partially executed on both sides, did not estop the vendor from setting up that the contract was ultra vires on the part of the defendant. The court, speaking through Judge Cooley, said:

> "Parties may also be estopped, in some cases, from disputing the validity of a corporate contract when it has been fully performed on one side, and when nothing short of enforcement will do justice. * * * But this is not such a case. The contract has only been performed in part. * * * the defendant will lose nothing but the anticipated profits on the remainder if the contract is not enforced in its favor. Those profits it had no right at any time to bargain for."

(2 a) *Apparent exceptions to the foregoing.*

The following cases have sometimes been cited as holding contrary to the general rule which has just been considered: *Lemp Hunting & Fishing Club vs. Cottle* (1913), 172 Mo. App. 574, 156 S. W. 799. *Same vs. Hackman,* 172 Mo. App. 549, 156 S. W. 791. *Mutual Life Ins. Co. vs. Stephens,* 214 N. Y. 488, 108 N. E. 856. But it seems to the writer, that these cases are distinguishable upon the ground that the contracts in question were really fully performed on one side.

(2 b) *Exceptions to the general rule.*

There is a Nebraska case, however, which seems in direct conflict with the rule that we have heretofore considered. *Cole-*

ridge Creamery Co. vs. Jenkins, 66 Neb. 129, 92 N. W. 123. In that case, the defendant had contracted to sell to a corporation of which he was a member, a certain tract of land for $60. Relying on this contract, the plaintiff corporation erected improvements on the lot of the value of $3000. The defendant vendor refused to convey. In an action by the corporation for specific performance of the contract, the defendant objected that the plaintiff had not proven that the land was necessary for its business. But the court held that the defendant could not avail of such defense, since the improvements had been made with the defendant's knowledge, assistance and approval, and that,

> "to permit him to question the right of the corporation to take and hold the property at this time would result in a gross fraud."

In this connection, it is interesting to note Judge Cooley's decision in Day vs Spiral Springs Buggy Co. It was there said, in effect, that even if the contract is only partially performed, the unperformed residue may be enforced, "when nothing short of enforcement will do justice." And before denying enforcement of the balance of the partially performed contract involved in that case, the court carefully examined the facts to discover whether or not enforcement was necessary as the only means of saving the defendant corporation from hardship or injustice. Having decided that justice did not require such enforcement, the claim of ultra vires was allowed.

(3) *The Wisconsin rule as to enforcement of the executory residue.*

As a general proposition, the Wisconsin rule in this respect, is in accord with the majority rule heretofore considered. That is to say; if either party to a partially executed ultra vires contract refuses to perform, he cannot be made to do so, nor can he be made liable in damages for breach of contract; but the other party to the agreement may recover in quantum meruit what he has parted with under such contract. *Northwestern Union Packet Co. vs. Shaw,* 37 Wis. 661. In that case the defendant had received $1000 from the plaintiff, and although refusing to perform any part of the contract, on ground that it was ultra vires, sought to retain the money received there-

under. Sole remedy of plaintiff was the recovery, in quantum meruit, of the money.

Other Wisconsin cases, however, seem to establish a further rule, which may be stated to be: That whenever the denial of enforcement to the unexecuted residue of a partially performed ultra vires contract would work great hardship or injustice upon the party not in default, then the court will enforce such executory residue.

In support of this rule, the language in *Bullen vs. Milwaukee Trading Co.*, 109 Wis. 41,45, is important as showing the tendency of the court to relax the rule of ultra vires. It was there said:

> "The doctrine of ultra vires cannot be invoked by a corporation for the purpose of escaping a burden resulting from a contract so far executed that the corporation has received the benefit thereof."

Just what is meant by the words "so far executed" is uncertain; but since the contract before the court was apparently fully performed on one side, the language should be restricted accordingly.

The above rule, however, seems to find adequate support in the case of *Wuerfler vs. Trustees Grand Grove W. O. D.*, 116 Wis. 19. In that case the defendant had issued a policy to one Wuerfler for $1000, which was ultra vires, as it had power to insure not in excess of $500. After the insured had acted on this policy for about three years, the defendant repudiated it as ultra vires, and demanded a surrender of the policy. The insured refused to do this. Three months after the repudiation, the insured died. The court stated the question to be whether or not the ultra vires policy was binding at the time of its repudiation. In deciding that the contract could not be repudiated at such time, the court, speaking through Judge Marshall, at page 625, said:

> This case is ruled, "by the familiar doctrine that when a contract made by a corporation has been *so far executed* that to allow the corporation to repudiate it *would work injustice* to the other party thereto, who has in good faith relied thereon, the doctrine of estoppel applies and prevents such repudiation regardless of whether the corporation had a right to make it or not, unless its act in that regard was in violation of some written law of the state or sound public policy; that in such circumstances, if the corporation exceeds its power, it commits a punishable offense against the sovereignty of the people, but cannot itself invoke the doctrine of ultra vires to avoid its act, at the same time in-

> flicting a grievous wrong upon the one who has in good faith relied upon the assumption that it possessed in fact the power which it pretended to have authority to exercise."

Although it is clear, that at the time of the attempted repudiation, the contract was not fully performed on either side, the court, in order to prevent manifest injustice being done the insured, enforced the executory residue against the defendant. The rule in this case would seem to be supported in some cases, heretofore considered, in other states. *Coleridge Creamery Co. vs. Jenkins,* 66 Neb. 129, *Day vs. Spiral Springs Buggy Co.,* 57 Mich. 146.

In a later Wisconsin case, there is dicta to the effect that even if an ultra vires contract is wholly executory, it may be enforced if there are grounds of equitable estoppel in the case which require it. *Ledebuhr vs. Wis. Trust Co.,* 117 Wis. 657. It was there said, at page 662:

> "But if the charter itself required the beneficiary to be named in the certificate, then the rule applies that the defense of ultra vires cannot be used to defeat a claim against a corporation unless the contract involved is wholly executory and there are no grounds of equitable estoppel in the way, or it is prohibited by statute or sound public policy. When a corporation violates its organic act it commits an offense against the sovereignty of the state, which only the state can punish by proceedings to forfeit its charter, in the absence of some other method provided by statute. That doctrine has become firmly established and early cases not wholly in harmony therewith must be considered to have been displaced by the later development of the law."

III. *MEASURE OF RECOVERY WHERE ENFORCEMENT OF THE EXECUTORY RESIDUE OF A PARTIALLY EXECUTED ULTRA VIRES CONTRACT IS DENIED*

(a) *Will party not in default be allowed recovery in quantum meruit as respects that part of the contract which has been executed?*

Most courts hold that recovery can be had only in quantum meruit. The leading case on this point is *Central Transportation Co. vs. Pullman's Palace Car Co.* (1890), 139 U. S. 24. That was a suit by the lessor company to recover past due instalments of rent according to the terms of an ultra vires lease, which at time of the suit, was but partially performed. The court held

that no recovery of rent could be had in an action upon the contract. It was said:

> "A contract ultra vires being unlawful and void, not because it is in itself immoral, but because the corporation, by the law of its creation, is incapable of making it, the courts, while refusing to maintain any action upon the unlawful contract, have always striven to do justice between the parties, so far as could be done consistently with adherence to law, by permitting property or money, parted with on the faith of the unlawful contract, to be recovered back, or compensation to be made for it.
>
> "In such case, however, the action is not maintained upon the unlawful contract, nor according to its terms; but on an implied contract of the defendant to return, or, failing to do that, to make compensation for, property or money which it has no right to retain. To maintain such an action is not to affirm, but to disaffirm, the unlawful contract."

Pursuant to this decision an action was brought in quantum meruit for past due instalments of rent, and such recovery was allowed. 171 U. S. 138.

The same rule applies in the Federal courts where the partially performed contract, in addition to being ultra vires, is also illegal. *Newcastle Northern R. Co. vs. Simpson,* 21 Fed. 533.

That recovery must be in quantum meruit, and not upon the contract itself so far as executed, seems to the Michigan rule. *Day vs. Spiral Buggy Co.,* 57 Mich. 146. It is the Wisconsin rule. *N. W. U. Packet Co. vs. Shaw,* 37 Wis. 661. The court, in the latter case, said:

> "we hold in this case, that so far as the action is founded on the void agreement, it cannot be maintained."

This is also the rule in Mississippi. *Greenville etc. Warehouse Co. vs. Planter's etc. Warehouse Co.,* 70 Miss. 669, 13 So. 879.

(b) *Will the party not in default be allowed recovery upon the contract itself so far as it has been executed?*

There is good authority for this view. *Bath Gas Light Co. vs. Claffy,* 151 N. Y. 24, 45 N. E. 390. In that case it was said:

> "as between the parties, so long as the occupation under the lease continued, the lessee was bound to pay the rent, and that its recovery may be enforced by action *on the covenant.* Public policy is promoted by the discouragement of fraud and the maintenance of the obligation of contracts, and to permit a lessee of a corporation to escape the payment of rent by pleading the incapacity of the corporation to make

> the lease, although he has had the undisturbed enjoyment of the property, would be, we think, most inequitable and unjust."

The Texas courts also favor this view. *Sabine Tram Co. vs. Bancroft,* 40 S. W. 837.

IV. *RESCISSION OF PARTIALLY EXECUTED ULTRA VIRES CONTRACTS*

The mere fact that one has parted with property under an ultra vires contract, such as a lease, does not authorize such person to retake such property by his own act and without process of law. *A. & P. Tel. Co. vs. U. P. R. Co.,* 1 Fed 745. When therefore, the lessee has not repudiated the contract, the lessor, in order to recover his property is obliged to come into court for the cancellation of the ultra vires lease As the lessor must come into court with clean hands, he will be required, as a condition precedent to a decree of rescission, to return to the lessee so much of the consideration for the lease which he has received from the lessee, as is equitable and just. Ibid. Of course, in many cases involving partially executed ultra vires contracts, the question of the right to rescind does not arise. Such is the case where one party to the contract has repudiated the contract and is sued by the other party to recover what has been parted with thereunder. *N. W. U. Packet Co. vs. Shaw.* The right to a decree of rescission can only come into question where one party to the contract seeks to be relieved from it and recover back property parted with thereunder, as against the other party who has not repudiated it.

Where there is a question of the right to rescind, the rule would seem to be: That if the contract is partially performed (or is so constructed), the right to rescind is recognized; but that if the contract is considered as being fully executed on the plaintiff's side, rescission will be denied. This rule is based primarily on Federal decisions. The underlying theory seems to be, that an ultra vires contract is governable by the same rules which apply to illegal contracts strictly so called; that if the plaintiff's side of the contract remains in part executory, he is not in pari delicto, and will be heard in court; that if the plaintiff has fully executed his side of the contract, he is in pari delicto and will not be aided by the courts. *St. Louis, Vandalia & Terre Haute R. Co. vs. T. H. & Ind. R. Co.* (1891), 145 U. S. 393. *Harriman vs. Securities Co.,* 197 U. S. 244, 295-6.

In the case in the 145 U. S. 393 the plaintiff had leased its road to the defendant for 999 years, and at the end of 17 years brought and action to rescind the contract and cancel the lease on the ground that it was ultra vires. The lessee had not repudiated the lease and had performed it to date. The court in denying the prayer for cancellation said that the contract was ultra vires,

> "and therefore did not bind either party, and neither party could have maintained a suit upon it, at law or in equity, against the other." And continued, "It does not, however, follow that this suit to set aside and cancel the contract can be maintained. * * * The general rule, in equity, as at law, is *In pari delicto potior est conditio defendentis;* and therefore neither party to an illegal contract will be aided by the court, whether to enforce it or to set it aside. If the contract is illegal, affirmative relief against it will not be granted, at law or in equity, unless the contract remains executory, or unless the parties are considered not in equal fault," etc. "When the parties are in pari delicto, and the contract has been fully executed on the part of the plaintiff, by the conveyance of the property, or the payment of money, and has not been repudiated by the defendant, it is now equally well settled that neither a court of law nor a court of equity will assist the plaintiff to recover back the property conveyed or money paid under the contract." Further, "The contract has been fully executed on the part of the plaintiff by the actual transfer of its railroad and franchise to the defendant; and the defendant has held the property, and paid the stipulated consideration from time to time, for seventeen years, and has taken no steps to rescind or repudiate the contract."

The difficulty with the foregoing case is whether or not the court correctly decided that the lease in question was executed on the lessor's side. In another part of this article, cases within the same jurisdiction have been cited which hold that leases of this kind are not fully performed on the lessor's side.

Where the contract is regarded as partially performed only, the right to rescind is recognized. *Newcastle Northern R. Co. vs. Simpson,* 21 Fed. 533. Property parted with under such contract, or the value of services and materials furnished in its partial execution, may be recovered. Ibid. In that case the court said:

> "There can be no doubt that a court of equity may entertain a bill to avoid a contract of a corporation which it had no power to make. * * * and so long as the contract continues executory, the maxim 'in pari delicto' does not apply at all."

The same principle is applied in *McCutheon vs. Merz Capsule Co.* (1896), 71 Fed. 787.

In the few cases of rescission that have arisen in the State courts, the Federal rule on the subject seems to have been followed; so that where an unexpired lease is regarded as a contract executed on the lessor's side, cancellation will be denied, so long as the lessee has not repudiated it. *Pittsburgh etc. R. Co. vs. Altoona etc. R. Co.*, 196 Pa. St. 452, 46 Atl. 431; but where such a lease is construed as a partially executed contract, the lessor's right to rescind is recognized. *Memphis & C. R. Co. vs. Grayson*, 88 Ala. 572, 7 So. 122.

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